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Latin America

REGIONAL AND POLITICAL ANALYSIS

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Chilean Payments Position: Breathing Spell 15C

Two years of harsh austerity have reduced Chile's financial gap* to a manageable size. The military junta is now gradually easing austerity and allowing imports to increase by 15 to 20 percent this year. Although Santiago is counting on increased commercial bank and supplier credits, it will have to draw heavily on its small foreign reserves to cover this year's projected $900 million financial gap.

The military government's ability to further relax demand management policies will be constrained by sluggish copper prices and difficulties in obtaining more foreign capital. Availability of foreign funds depends partly on the junta's willingness to curb its human rights violations. The recent announcement that the government has disbanded the National Intelligence Directorate (DINA) seems to be a genuine effort to curtail past abuses and modify the most severe aspects of political repression. Given the prospects for aid, even with improved human rights policies, Chile's growth for the next few years will not support a sharp rise in the living standards of most of the population,

The Allende Legacy and the 1975 Crisis

Chile's precarious payments position--in large part the aftermath of economic mismanagement by the Marxist regime of Salvador Allende (1970-73)--developed into a financial crisis in 1975. The crunch was brought on by the collapse of world copper prices and the due data

*Financial gap is defined as the current-account deficit plus amortization of medium- and long-term debt; shifts in short-term capital are not included.

[redacted]
25 August 1977

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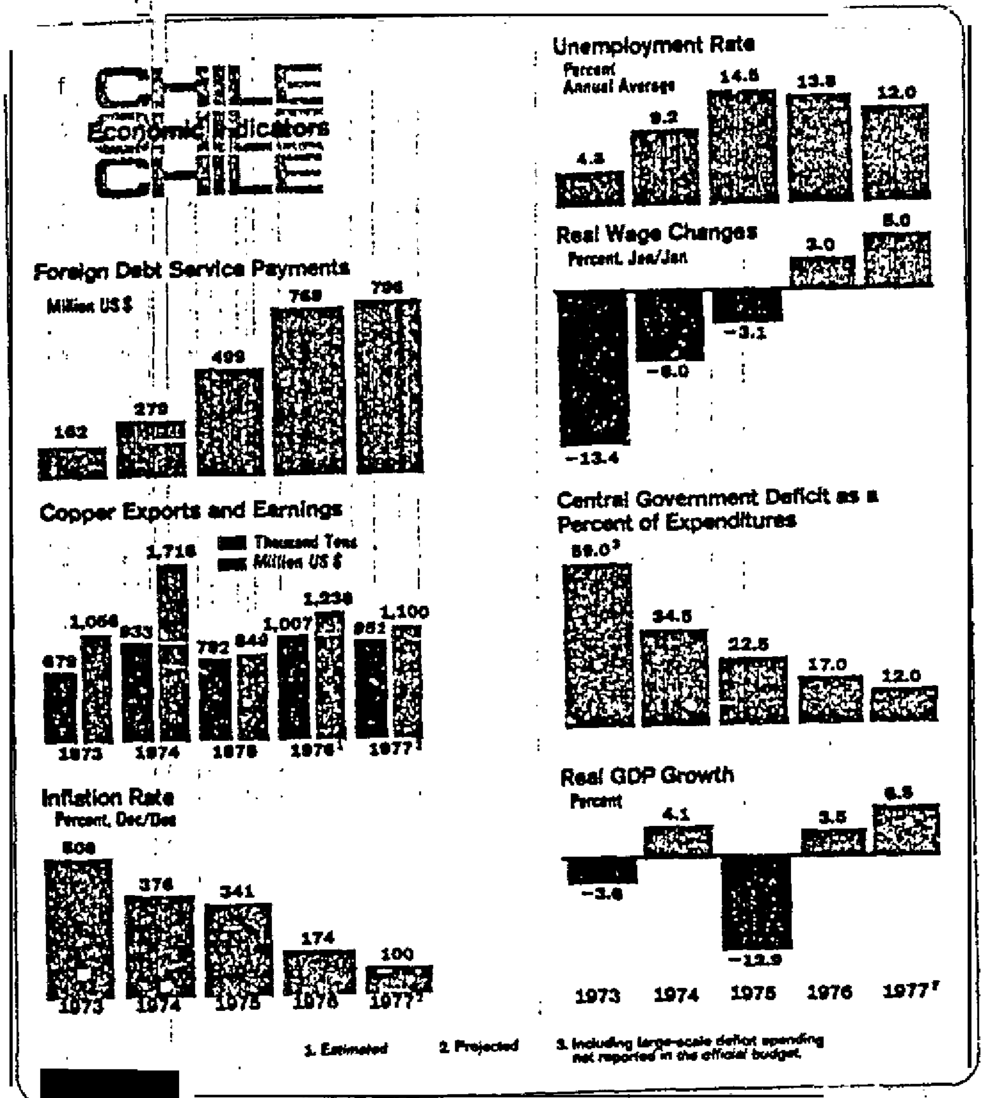

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[redacted]
25 August 1977

SECRET

of large scheduled debt repayments, which pushed the current-account deficit to $580 million and the financial gap to $1.1 billion. The gap was closed only by postponing roughly a third of the $730 million in scheduled debt repayments. 15C

To prevent an even larger deficit and ease the inflation rate, the new military government--which had seized power in September 1973--imposed an austerity program. Private sector credit all but disappeared in 1975, while government spending was slashed by one fourth. The squeeze on domestic demand cut the volume of foreign purchases by nearly one fifth; real GDP fell 13 percent and industrial output plummeted 28 percent. From the viewpoint of the military government, such unpopular and wrenching changes could be installed only by tightening the junta's already strong political grip on institutions and individuals.

Restoring Equilibrium in 1976

The effects of the austerity program carried over to 1976 when import volume fell another 13 percent to about the 1972 level. At the same time, Chile benefited from the recovery in copper prices and from rapidly expanding non-copper exports, the result of a vigorous export promotion campaign and devaluation of the peso roughly in line with the country's triple-digit inflation. Total exports gained more than 30 percent in value, allowing a small currant-account surplus and more than halving the financial gap to $500 million.

By narrowing the gap, Santiago was able to meet scheduled debt repayments for the first time since 1971. Private foreign lenders, encouraged by the government's belt-tightening and improved ability to repay its debts, provided about a $100 million increase in long-term capital last year, more than offsetting a fall in official lending brought on by Chile's human rights policies. These funds, together with $80 million in direct investment inflows, closed the financial gap and permitted a substantial increase in foreign exchange reserves. By the end of the year, reserves amounted to about four month's imports.

[redacted]
25 August 1977

The improved payments situation paved the way for the gradual easing of fiscal and monetary restraints beginning in mid-1976. Despite somewhat easier private credit and increased foreign demand, real GDP rose rose only 3.5 percent and industrial output recovered by a mere 6.5 percent. The Strongest revival occurred in the copper industry where output last year averaged 1 million tons, up from 828,000 tons in 1975. The growth in economic activity barely put a dent in the record unemployment rate. The inflation rats, fueled by Continued large budget deficits and parallel monetary growth, averaged 174 percent for the year as a whole, compared with 341 percent in 1975. 1.5C

The 1977 Payments Situation

Ha expect Chile's financial gap to widen by more than 80 percent this year, to about $900 million. Although foreign sales are being bouyed by non-copper export earnings, sagging copper demand and prices will prevent any increase in total exports. Copper shipments this year will total about 951,000 tons, down 6 percent from last year, while copper earnings are projected to slip more than 10 percent.

'At the same tine, Santiago is providing enough reflation to Induce a 15- to 20-percent rise in imports, leaving a trade surplus of $350 million this year. The deficit in transportation, other services, and interest payments, together with debt amortization costs, will leave Chile with the estimated financial gap of about $900 million in 1977.

The military government is relying on commercial bank borrowing and expanded use of supplier credits to finance the payments gap. Anticipating criticism and pressure from the US and other creditors for its human rights practices, Santiago has forgone negotiations for debt relief again this year. For the same reason, borrowing from bilateral and multilateral sources is off Sharply. Funds from these sources will amount to less than half of last year's inflows. Direct investment will not grow much, partly because of bureaucratic delays in approving new projects. Consequently, a decrease in reserves of nearly $200 million probably will be required this year.

[redacted]
25 August 1977

To keep import growth within bounds and maintain progress against inflation, the junta is staying with its plan to ease austerity measures only gradually. Real wages this year are being allowed to increase only about 5 percent, leaving them still well below 1972 levels. On the budgetary side, Santiago's program calls for moderate tax reductions, small increases in social spending, and some limited wage increases for government workers. In these circumstances, Santiago will run a budget deficit equal to 12 percent of government expenditures, 5 percentage points smaller than last year. Consumer credit is also being eased, but notvery feet. 1.5C

On balance, we estimate that these measures will allow real GDP to rise by close to the junta's 6 to 7 percent target this year. Real output for 1977 will still be slightly below the 1974 level, unemployment will remain at about 12 percent, and inflation is likely to average about 100 percent. Given the authority of Me junta, Chilean labor is in no position to protest the slow revival in its real income. For its part, the business community still feels it is better off under the present regime than under the Allende government.

Looking Ahead

Unless world copper prices rise more than CM reasonably be expected, the military government will be unable to further relax its austerity measures over the next few years and may have to tighten them again. Debt amortization payments will not begin to decline until after 1980, and obtaining external financing will continue to be a serious problem. By the end of this year, foreign reserves will be down to two month's import cover and thus cannot continue to underwrite increased imports. ~~Without higher copper prices~~, Santiago needs $800 million to $900 million a year in gross capital inflows if the junta's target of 6 to 7 percent economic growth is to be met. Even though the junta seemingly is relaxing its human rights attitudes, Chile cannot count on filling much of the gap with bilateral or multilateral financing.

[redacted]
25 August 1977

Substantial increases in direct foreign investment are also unlikely over the next few years. Thus, the outlook is for prolonged constraints on imports, slower economic growth, and continued high unemployment levels. 1.5C [redacted]

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25 August 1977